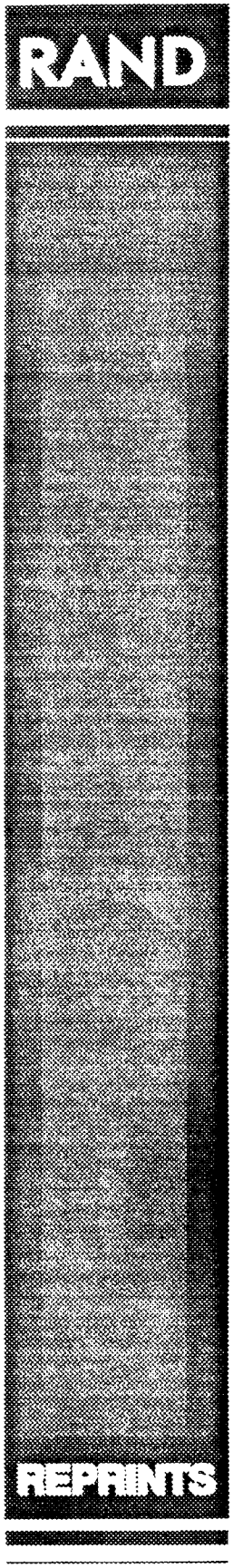

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The New Mercantilism

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CHARLES WOLF, JR.

IN ONE OF HIS many insightful observations, John Maynard Keynes noted that "practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist." He noted further that the power of ideas can be immense "both when they are right and when they are wrong," concluding that "it is ideas, not vested interests, which are dangerous for good or evil."

One of these currently captivating ideas is that aggressive government actions—including "strategic trade policy," "industrial policy," and "technology policy"—will bring about increased American "competitiveness" overseas. It can be argued that Keynes' insight is wide of the mark in this instance because the principal sources of these ideas are not defunct, but alive, articulate, and influential. They include such academic economists as Paul Krugman at MIT,[1] John Zysman at Berkeley, Lester

[1]Although Krugman is, in some ways, the intellectual guru of the group, he has recently veered sharply away from it. He argues now that the emphasis on international "competitiveness" is misconceived and even "dangerous," because it diverts attention from the central problems of productivity growth and the domestic economy. See Paul Krugman, *Peddling Prosperity: Economic Sense and Nonsense in the Age of Diminished Expectations*, W. W. Norton, 1994.

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Thurow at MIT, and Laura Tyson, formerly at Berkeley and currently chairman of the Council of Economic Advisors, and numerous well-known commentators and popularizers, including Clyde Prestowitz, James Fallows, Chalmers Johnson, Pat Choate, and Karel van Wolferen. However, Keynes' original insight can be defended by a reasonable counterargument: antecedents of these current ideas can be traced to several defunct mercantilists of bygone centuries, including Jean Baptiste Colbert, Thomas Mun, Antonio Serra, Friedrich List, and Alexander Hamilton, who advocated state action to promote specific exports, to restrict specific imports, and to accumulate gold bullion, trade surpluses and, it was believed, enhanced state power. The current renditions by the new mercantilists are more elegant and sophisticated, but their origins are unmistakable.

"Industrial policy" and "strategic trade policy" differ from one another, in some respects. Industrial policy focuses on the development of key domestic industries and technologies, with international trade accorded a secondary role. Strategic trade policy focuses on international trade, on promoting specific exports and limiting specific imports. Strategic trade policy includes, as well, the use of threats and the imposition of penalties to pry open foreign markets. A recent example is the U.S. threat to impose high countervailing tariffs on Japanese imports—by reactivating the "Super 301" provision of the trade legislation of 1988—unless U.S. exports of automobiles and auto parts reach certain specified shares of Japan's domestic market for these products.

Nevertheless, despite the differences between strategic trade policies and industrial policies, they share a fundamental premise: government should select certain industries, technologies, and firms whose advancement is of "critical" importance for the economy as a whole, and accord the selected ones some form of preferential treatment—whether through subsidies, tax advantages, import restrictions, special efforts to promote exports, or direct government financing for "precommercial development" of putatively critical technologies.[2] To some, "critical" means high technology industries in general (Tyson); to others, it means this as well as certain specific sectors, such as semiconductors

[2]A new government agency—the National Institute of Standards and Technology, formerly the Bureau of Standards—has been given the principal responsibility for this latter task, and a three-fold budget increase to accomplish it.

(Fallows), or telecommunications, or automobiles, or machine tools, or even rice. In the interest of simplicity, and at a modest cost in precision, I will refer to both sets of policies as "preferential industrial and trade policies," or PITP.

The appeal of PITP to many "practical men" (as well as some impractical ones) is understandable because there are reasonable theoretical arguments as well as empirical evidence and experience to support it. What is usually overlooked by those who accept the arguments for PITP, however, is the existence of strong counterarguments, as well as indications that the usually cited evidence in support of PITP is at best ambiguous, and probably wrong. While the Japanese experience is usually cited in support of PITP, there is a simpler and more compelling explanation for Japan's success. Moreover, if a vigorous set of preferential policies were to be pursued in the context of the U.S. political system, there are strong reasons for expecting them to fail badly.

In the following discussion, I will first summarize the theory that provides support for PITP, next consider the theory's shortcomings, then elaborate a countervailing view, and thereafter suggest why efforts to implement PITP in a pluralistic, interest-group democracy such as our own can be expected to generate costs and mistakes that exceed the potential benefits. Along the way, I will suggest that Japan's notable economic and technological accomplishments—notwithstanding a current recession that has been deeper and longer than the prior one of the United States, and seems likely to continue—are attributable to factors other than Japan's neo-mercantilist policies.

The case for intervention

The intellectual basis for PITP rests on several well-established economic precepts: first, "economies of scale"—the notion that large firms can realize certain efficiencies not accessible to small ones; and second, "economies of learning"—the notion that individuals and firms that have acquired abundant experience are more efficient than those with less.

A corollary of these gains is the existence of certain spillover benefits ("externalities") that are presumed to accrue to other industries or to the economy as a whole. These externalities—benefits external to the firm or industry generating them, and

not susceptible to its control or exploitation—may be of several types and may arise in various ways. For example, if a firm or industry achieves substantial size, it may provide a large market that redounds to the advantage of feeder industries, firms, and suppliers. Thus the large size of the automotive industry provides opportunities for electronics, tire, lighting, and other component producers that, in turn, enable them to increase their own efficiency through larger scale production. Economists refer to these spillovers as "pecuniary externalities."

Another type of spillover—referred to as "technological externalities"—may result from the experience, learning, and accumulated know-how of the originating firm or industry, and the more highly skilled labor pool that is thereby created, with potential benefits for other firms or industries. The development and remarkable growth of the Internet system, as a result of linking computers and telecommunications, provides a striking example of technological externalities that hugely benefit international business, finance, and commerce.

Is it better to be bigger?

Describing the importance of firm size, Laura Tyson asserts that: "In such [technology-intensive] industries, costs fall and product quality improves as the scale of production increases, [and] the returns to technological advance create beneficial spillovers for other economic activities" (Tyson, 1992). Economies of scale are typically represented by economists in the form of unit costs that decline as the scale of output increases. Economies of scale are traceable to the increased opportunities of large firms for division of labor and specialization of tasks, and for spreading fixed costs over a larger volume of output as production rises. Thus, supermarkets typically can underprice small grocers and profit from doing so. And, at least until recently, it has been presumed that large-scale steelmakers, such as USX or Kobe, can out-compete small steel producers because of the economies of scale the larger firms can realize.

"Economies of learning"—that is, efficiencies resulting from accumulated experience—are also presumed to result in lower costs, and to yield a competitive advantage for firms that have been in business for a long time. Economists use various proxies to measure experience: for example, the cumulative output of

individual firms, or the cumulative years they have been in business. The premise underlying these proxy measures is that the greater the cumulative output, or the greater the number of years of experience, the more proficient will be the firm's operations and the stronger its competitive position relative to less experienced firms. Thus IBM, General Motors, and Toyota have been presumed—at least in the past—to derive a competitive advantage from their accumulated learning and experience.

Economies of scale and learning, plus the corollary externalities with which they are associated, provide the intellectually respectable ideas that have led many to accept the case for strategic trade and industrial policy. Because of these economies, it is argued, government should establish one or another type of preference or subsidy to "establish a lead in an industry, [and] ... once this lead is established it becomes self-reinforcing and tends to persist" (Krugman, 1991). Tyson refers to the "first-mover advantages" that can be realized by dominant firms and technologies (Tyson, 1992).

It ain't necessarily so

So much for the theoretical arguments for strategic trade policy. The trouble is that there are equally convincing, although less familiar, theoretical arguments against them. There are strong reasons why large size and long experience may entail offsetting risks and disadvantages.

This debit side of the ledger consists of rigidities due to large scale, and the "diseconomies" that may be associated with learning and experience. The effect of these diseconomies may be to place large firms, or firms that have been in business a long time, at a competitive disadvantage. The case for small, new firms, in fact, is as strong as that for large, mature ones. Sometimes Goliath will win, other times David.

An inexact, but still relevant, indication of the disadvantages of large size is the relative change in employment in large and small firms between 1979 and the present: whereas large firms, defined as those with annual sales over $600 million, reduced employment by 29 percent (from 16 million in 1979 to 11.5 million in 1993), employment in small and medium firms grew by 28 percent (from 83 million to 106 million)!

Diseconomies of scale and experience may be especially acute

in an economy with increasing linkages between domestic and international markets. These linkages produce more rapid product and process innovation due to the faster transmission of information (additions to the Internet have recently been running at a rate of 12 percent per month!), increased trade in goods, services, and intellectual property (between 1986 and 1992 the growth in world trade was more than twice as fast as the growth in world output), and increasing mobility of capital (as reflected in the increasingly close alignment of real interest rates in international markets). In this rapidly changing environment, achievement of large scale and long experience may entail significant drawbacks—specifically, rigidities of scale and learning.

First, consider the rigidities that often characterize large organizations: the hierarchies, bureaucracies, standard operating procedures, and cumbersome administrative routines. These characteristics may create a gap between the production and marketing information that is available *outside* the large organization and the information actually utilized *within* it. The result is slower response and reaction times in large organizations. The limited and dilatory responses of General Motors to competitive challenges in the 1980s, and of IBM, Toyota, Daimler-Benz, Sears Roebuck, and American Express in the 1990s exemplify this tendency. To be sure, there are counterexamples: General Electric, Alcoa, Sony, and the "Baby Bells" following the breakup of AT&T have continued to be innovative despite their size. That diseconomies of scale exist does not imply that they cannot be surmounted, nor that they will always dominate the advantages of size discussed earlier.

Diseconomies of learning and experience can arise in ways similar to those associated with diseconomies of scale. Accumulated learning and experience may have a "lock-in" effect that induces overconfidence, lethargy, and a failure to absorb and respond to product and process innovations. These innovations might, for example, displace or encroach upon the product line or marketing style that the established firm has learned well, practiced long, and would like to protect. Again, there is a gap between the relevant information that is available *outside* the firm and what is actually acquired, absorbed, and utilized *within* it. As a result, the experienced firm may be less receptive to information about innovations than are newer and less experi-

enced firms. Apple's displacement of IBM in the personal computer business and Intel's major gains over Hitachi in semiconductors are cases in point.

Rigidities of learning may be likened to the familiar left-brain, right-brain duality: overdevelopment of the left brain may impede stimulus and insight from the right. Too much learning of one thing may come at the expense of reduced receptivity to others.

So the strong theoretical arguments in favor of preferential industrial and trade policies confront equally powerful arguments in opposition. Large size and accumulated experience confer initial advantages, but may entail later, offsetting disadvantages. This suggests there may be an optimum size—large, but not too large—and an optimum degree of experience—some, but not too much—for maximum competitiveness. "Practical men" can be liberated from the thrall of PITP by becoming aware that the supporting arguments are less convincing than presumed.

What about Japan?

Whatever the theoretical arguments, Japan's stellar economic performance is typically cited as a compelling example that PITP works. While, in fact, Japan's recent economic performance has been less than stellar—its negative real growth in 1992, and barely positive growth rate in 1993 (and probably also in 1994) are between 2 and 3 percentage points behind the corresponding rates in the U.S.—nevertheless, Japan's economy in the past two decades has seen remarkably rapid growth, aggressive development of high technology industry, and a large and continuing current-account surplus with the U.S. and the rest of the world.

Some observers attribute this record to the industrial and trade policies orchestrated by the Ministry of International Trade and Industry (MITI), and to various predatory Japanese business practices. These policies and practices include *keiretsu* industrial organizations, protection of the domestic market, discriminatory regulatory and contractual practices, and subsidized access to capital for selected manufacturing industries. James Fallows invokes all of these to account for the rapid and profitable development of Japan's semiconductor industry in the 1980s, while discounting if not dismissing the inconvenient fact that the profits and prospects of the principal movers in the industry—Hitachi,

Toshiba, and NEC—have plummeted sharply in the 1990s. Moreover, even if MITI's trade and industrial policies were successful in semiconductors, its overall batting average looks much less impressive when account is taken of its efforts in other manufacturing industries—notably steel, shipbuilding, and aircraft. For the six-year period from 1987 to 1992, global profits realized in all industries by Japanese businesses were less than one-third of those realized by U.S. businesses, while global sales by Japanese businesses were 20 percent less than those of U.S. firms.

In any event, while MITI's record is at best mixed, Japan's remarkable economic accomplishments over the past two decades can be understood and accounted for by simple explanations, without recourse to Japan's complex industrial and trade policies. The principle known as Ockham's razor suggests that simple explanations should be preferred to complex ones when both are available. Recourse to complexity should be made only when simple explanations prove inadequate.

The most compelling explanation for Japan's formidable economic accomplishments lies in four simple factors, some of which are likely to be transitory:

- Savings—Japan's domestic savings averaged 28 percent of GNP in the 1980s, compared with only 13-14 percent of GNP in the United States.
- Investment—Japan's annual rate of aggregate domestic investment averaged about 24 percent of its gross domestic product in the 1980s, compared with 15-16 percent in the U.S.
- Labor—Japan's work force is highly disciplined, trained, industrious, and literate.
- Management—Japanese managers are energetic, competent, and experienced, and they have learned—through international competition and the powerful dictates of the Japanese work ethic—to strive continually to improve product quality and cut production costs.

Japan's high domestic investment accounts for nearly all of the difference in average annual growth rates between Japan and the U.S. during the 1980s. (This estimate is based on the standard calculation that the ratio between increased investment and increased output is between three and four. During the 1980s,

Japan invested between 8 and 9 percent more of its GNP than did the U.S., and Japan's annual economic growth exceeded that of the U.S. by 2 to 3 percent.) Also, the investment difference largely explains Japan's strong performance in capital-intensive sectors such as automobiles, consumer electronics, and semiconductors. Investment and savings, taken together, account for Japan's persistent trade surpluses (explained by the excess of Japan's savings over investment), as well as the persistent trade deficits of the United States (explained by the excess of American investment over its savings). To be sure, policymakers in Japan have provided strong incentives to boost both savings and investment: for example, by reducing the taxation of income that is saved rather than spent, by forgoing the taxation of long-term capital gains, and by using a broader interpretation than the U.S. of what can be counted as "research and development" and thus can qualify for special tax advantages. These Japanese macroeconomic policies, which have strongly encouraged savings, long-term investment, and R&D, contrast with policies in the United States that have not. These Japanese policies have also been pursued by a government that, in relative terms, is about 20 percent smaller than that of the United States, as measured by the size of total government spending relative to GDP.

The factors noted above, together with Japan's high quality labor force and its management practices, account for the impressively rapid growth of Japanese productivity, although over the past four or five years the growth of U.S. labor productivity has equaled or exceeded that of Japan.

Once Japan recovers from its current severe recession, the country's savings rate may fall somewhat as a result of rising consumer demand and a population whose proportion of the aged is growing more rapidly than in the past, as well as more rapidly than that in the United States and other industrialized countries. Japan's rate of investment may also drop, due to tighter capital markets and a reallocation of resources from the private to the public sector. As a result, productivity growth will probably decrease.

In sum, application of Ockham's razor suggests that the principal explanation for Japan's impressive economic accomplishments, and for its prominent position in the world economy, is quite independent of its industrial policy and its "strategic," neo-

mercantilist trade practices.

This conclusion does not mean that U.S. negotiators, dealing bilaterally with the Japanese as well as multilaterally in GATT, should refrain from continued efforts to change Japan's mercantilist policies. On the contrary, the U.S. should seek to bring about liberalization even though it would benefit principally Japanese consumers and only secondarily American exporters (because the exporters in other countries would get some share of the increased trade with Japan that would result). It remains an unresolved question whether these changes are more likely to ensue through direct American pressure (*gaiatsu*), or instead through more indirect means, such as encouraging Japanese consumers to exert pressure internally (*naiatsu*), or through a combation of *gaiatsu* and *naiatsu*.

The politics of preferential policies

Even if the theoretical basis for PITP didn't suffer from the shortcomings discussed above, and even if the example of Japan provided clearer evidence in support, the political realities of attempting to implement such preferential policies in the U.S. would make this an unpromising course to follow.

"Strategic trade policy," "industrial policy," and "managed trade" inevitably imply that some industrial or technological categories—semiconductors, automobiles, electronics, machine tools, pharmaceuticals, or rice—would be chosen for preferential treatment because they are considered "critical" for one reason or another. In response to this, "rational" firms and trade associations could be expected to allocate time, attention, talent, and other resources to obtaining the potential preferences. Whether such efforts took the form of jawboning, elbow bending, contributions to election campaigns, or other forms of lobbying, these redeployments would be at the expense of more economically productive pursuits. The outcome of such interest-group competition would reward the most successful political representations, rather than the most technologically promising firms. There is no particular reason for expecting these two domains to coincide. Even if it could be argued convincingly that computer chips are different from potato chips because the former generate positive "externalities," the case for preferential policies would remain unconvincing because of political considerations. If such

policies were put into place, a swarm of second- and third-tier claimants would emerge with arguments for inclusion within the preferential safety net. And some of them would no doubt succeed in their efforts.

In sum, whatever the acknowledged shortcomings of the market and the merits of attempting to remedy them, employing preferential public policies toward this end would entail the risk of other shortcomings. That is not to say that remedial public policies should not be considered. Rather, it is to add a note of caution lest attempts to rectify the shortcomings of the market lead to the greater shortcomings of the proposed non-market remedies. Attempted therapies may be as bad as, or worse than, the maladies they are intended to cure. The most promising industrial and trade policy for the United States is to persist in ratifying and implementing NAFTA and the recently concluded Uruguay Round of GATT, thereby promoting more open and competitive international markets for services and intellectual property, as well as commodities.